Turkish Online Journal of Qualitative Inquiry (TOJQI)
Volume 11, Issue 4, October 2020: 718- 725

Research Article

Internal Control over External Financial Reporting (ICEFR): A Compendium of Approaches

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Abstract

According to COSO, the intent of the Compendium is to help users apply the New Framework to internal control over external financial reporting (ICEFR). Therefore, the Compendium is a companion publication to the New Framework that provides approaches and examples to illustrate how entities may apply the principles set out in the New Framework to a system of ICEFR. It provides practical approaches and examples that illustrate how the components and principles set forth in the New Framework can be applied in designing, implement-ing and conducting internal controls over the preparation of external financial statements. The approaches and examples relate to each of the five components and 17 principles set forth in the New Framework and illustrate how various characteristics of principles may be present and functioning within a system of ICEFR objectives; however, they do not attempt to illustrate all aspects of the components and relevant principles necessary for effective ICEFR. The approaches describe how organizations may apply the related principles within their system of ICEFR to give users a summary-level description of activities that management may consider as they apply the New Framework in an ICEFR context. The examples provide specific illustrations to users on the application of each principle, based on situations drawn from practical experiences and illustrating one or more points of focus germane to the principle.

Keywords*: Internal Control over External Financial Reporting (ICEFR), COSO.*

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1. INTRODUCTION

In 2013, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released an update to its Internal Control—Integrated Framework (Framework). The original framework which was etabilished in 1992 has gained broad acceptance and is widely used around the world. It is recognized as a leading framework for designing, implementing, and conducting internal control and for establishing requirements for an effective system of internal control.

To help users apply the Framework to internal control over external financial reporting, COSO has released this companion publication, Internal Control over External Financial Reporting: A Compendium of Approaches and Examples (Compendium). More specifically, the Compendium provides approaches and examples to illustrate how entities may apply the principles set out in the Framework to a system of internal control over external financial reporting.

COSO's Internal Control—Integrated Framework (Framework) sets forth three categories of objectives: operations, reporting, and compliance. The focus of this study, Internal Control over External Financial Reporting: A Compendium of Approaches and Examples (Compendium) is the external financial reporting category of objectives, a subset of the reporting category.

While the Compendium is a valuable tool in the hands of companies that will rely on the COSO Framework in developing strong systems of internal control, it has the potential to lead to comparability at the expense of quality controls. For example, some prior research indicates that decision aids in auditing contexts may cause decision aid users to approach tasks mechanistically rather than becoming involved in the task judgmentally (Glover et al. 1997).

The paper reviews the description and discussion of the associations among the five COSO components as well as relevant literature to investigate the association among the COSO components.

2. LITERATURE REVIEW

COSO framework defines internal control as a process affected by an entity's board of directors, management, and other personnel and covering the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations

An effective internal control system requires to identify and understand the dimensions of the controls and their importance in achieving the results of an organization (Imoniana, et al, 2011). It emphasizes that senior management, the board of directors, or an equivalent oversight body should lead by example in developing values, an enterprise philosophy, and an operating style in the pursuit of the enterprise's objectives. What senior management does and says really sends a message to everyone associated with the enterprise.

COSO framework has been the design and implementation of systems of internal controls over external financial reporting that support the preparation of financial statements. These applies to any types of entities such as public entities, private, non-profit, and governmental entities, all of which have external financial reporting requirements.

A significant component of an effective system of internal control for an enterprise relate to the preparation of reliable financial and non-financial internal and external reports (Kholis et al., 2020). External financial reporting must be prepared based on generally accepted accounting principles that are suitable and available for an entity and appropriate in the condition. The preparation of financial statements is derived from an enterprise's financial and accounting books and records, including annual and interim financial statements.

External financial reports may also include financial reports prepared for taxing authorities or regulatory agencies or requirements established through contracts and agreements. Other external financial reporting objectives may include news releases, earnings releases, or financial information posted on enterprise websites.

Although external financial reports are a major area of concern to enterprise management, they are often a small component of overall enterprise reporting requirements. Internal reporting objectives are driven by an enterprise's internal needs to satisfy strategic objectives, operating plans, and performance metric requirements at various levels and units within the enterprise. Although the emphasis of COSO internal controls is on external reporting, enterprise internal reporting should be at least equally important.

These internal reports are often consolidated to form the basis for external reports. Our discussions of COSO internal controls will emphasize internal reporting and related management concerns in many of the following sections.

3. METHODS

The descriptive approach was adopted in this study through the collection of previous literature on COSO 2013 Internal Control—Integrated Framework (Framework) and provides approaches and examples to illustrate how entities may apply the principles set out in the Framework to a system of internal control over external financial reporting. This study will provide a theoretical overview of Internal Control over External Financial Reporting.

The aim of the paper is to help users apply the Framework to internal control over external financial reporting, COSO has released this companion publication, Internal Control over External Financial Reporting: A Compendium of Approaches and Examples (Compendium). More specifically, the Compendium provides approaches and examples to illustrate how entities may apply the principles set out in the Framework to a system of internal control over external financial reporting. A number of published articles has also been examined to get a view of the researchers in this area.

4. RESULTS DAN DISCUSSION

4.1. Result

Some authors have studied the COSO Framework to provide some clarity dan guidance. There are largely examined each COSO component separtely. The COSO five-component are

1) Control Environment
   The control environment is the set of standards,processes, and structures that provide the basis for carrying out internal control across the organization. The board of directors and senior management establish the tone at the top regarding the importance of internal control including expected standards of conduct. Management reinforces expectations at the various levels of the organization
2) Risk Assesment
   Risk is defined as the possibility that an event will occur and adversely affect the achievement of objectives. Risk assessment involves a dynamic and iterative process for identifying and assessing risks to the achievement of objectives. Management specifies objectives within categories relating to operations, reporting, and compliance with sufficient clarity to be able to identify and analyze risks to those objectives. Management also considers the suitability of the objectives for the entity.
3) Control Activities

Control activities are the actions established through policies and procedures that help ensure that management's directives to mitigate risks to the achievement of objectives are carried out. Control activities are performed at all levels of the entity, at various stages within business processes, and over the technology environment

4) Information and Communication
Information is necessary for the entity to carry out internal control responsibilities to support the achievement of its objectives. Management obtains or generates and uses relevant and quality information from both internal and external sources to support the functioning of internal control. Communication is the continual, iterative process of providing, sharing, and obtaining necessary information. Internal communication is the means by which information is disseminated throughout the organization, flowing up, down, and across the entity.
5) Monitoring Activities
Ongoing evaluations, separate ealuations, or some combination of the two are used to ascertain whether each of the five components of internal control, including controls to effect the principles within each component, is present and functioning.

In the twenty years since the release of the original framework, business and operating environments have changed dramatically, becoming increasingly complex, technologically driven, and global. At the same time, stakeholders have become more engaged, seeking greater transparency and accountability for the integrity of systems of internal control that support business decisions and governance of the organization. The key elements of The Framework and the Compendium incorporate many of these changes including (COSO, 2013):

- Expectations for Governance Oversight : Higher regulatory and stakeholder expectations require the board of directors to oversee internal control over external financial reporting. Some jurisdictions require specific regulatory requirements for expertise and independence of board members of certain types of entities.
  Topic includes related to Expectations for Governance Oversight: Assessing and Disclosing Director Qualifications, Assessing the Potential of Management Override, Changing the Board Composition of a Closely Held Company, Facilitating Communication between Executive Management and the Board of Directors, Maintaining Oversight, Reviewing and Documenting Key Activities of the Audit Committee, Reviewing Financial Statement Estimates, Reviewing Governmental Agency Financial Results and Underlying Internal Control.
- Globalization of Markets and Operations : Organizations expand beyond domestic markets in the pursuit of value, often entering into international markets and executing cross-border mergers and acquisitions.
  Related topics include assesment what to do about Automating Balance Sheet Reconciliations, Changes in Business Operations, Conducting Senior Financial Officer Visits, Reorganizing to Support Control Structure
- Changes and Greater Complexities in the Business : Organizations change business models and enter into complex transactions in pursuit of growth, greater quality, and productivity, and in response to changes in market and regulatory environments. These changes may include entering into strategic alliances, joint ventures, and other complex contractual arrangements with external parties, implementing shared services, and engaging outsourced service providers.
  Topics discused mainly are Roles and Responsibilities with Objectives, Establishing Periodic Communications with Contractors and Outsourced Service Providers, Evaluating Business Activities to Identify Information Requirements, Implementing or Assessing Control Activities when a Report on Controls at a Service Organization is Not Available, Maintaining Control while Engaging Outside Service Providers, Obtaining a Report on Controls at a Service Organization from a Cloud-Based Service Provider, Obtaining a Report on Controls

at a Service Organization from a Service Payroll Provider, Obtaining Information from External Sources to Assist with Accounting, Estimates, Reorganizing to Support Control Structure, Responding to Significant Change from an Acquisition, Retaining External Tax Assistance, Reviewing the Service Auditor's Report for Changes in Controls

- Demands and Complexities in Laws, Rules, Regulations, and Standards ; Regulators and policy makers promote greater investor protection and confidence in the financial reporting systems through changes in rules, regulations, and standards. Also, users of external financial reports seek greater amounts of information to better evaluate an entity's financial condition and operating results as businesses become more complex.
  Sample by topics are Analyzing Risks from External Factors, Assessing the Suitability of Specified Objectives, Controlling Significant Accounting Estimates, Establishing Policies and Procedures, Establishing Responsibilities for Reviewing Financial Statements, Implementing Complex Accounting Standards, Obtaining Information from External Sources to Assist with Accounting Estimates, Reviewing and Updating Statutory Reporting Requirements, Reviewing and Updating Understanding of Applicable Standards, Using Templates to Document Policies
- Expectations for Competencies and Accountabilities ; Demands for greater competence and accountability increase as organizations grow; acquire entities; introduce new products and services; comply with complex rules, regulations, and standards; and implement new processes and technologies. Organizations may flatten and shift management operating models and delegate greater authority or accountability to certain roles.
  The topics are Ad Hoc Assessing of Control Activities, Aligning Competencies with Key Financial Reporting Positions, Assessing and Disclosing Director Qualifications, Assessing the Adequacy of Staffing Levels for Financial Reporting, Audit Committee Review of Managers' Roles, Planning for Executive Transition, Recruiting and Retaining Key Financial Reporting Positions
- Uses of, and Reliance on, Evolving Technologies ; An increasingly mobile and interconnected world has made technology more essential for many organizations to improve performance, business processes, and decision making. Entities are investing in emerging technologies, such as cloud computing, mobile devices, and social media, and using enterprise resource planning (ERP) and other technologies to standardize, automate, and streamline business processes.
  Topics include Analyzing Risk for Information Technology, Analyzing Risks from External Factors. Automating Balance Sheet Reconciliations, Capturing Information through Electronic Data Interchange, Data Capture and Processing for the Purchasing and Payables Cycle, Establishing Logical Security, Evaluating Business Activities to Identify Information Requirements, Evaluating Financial Close End-User Spreadsheet Control Activities, Identifying and Classifying Data for Financial Reporting, Managing Changes to Custom Software, Managing Changes to Packaged Software, Obtaining a Report on Controls at a Service Organization from a Cloud-Based Service Provider, Using a Data Warehouse to Facilitate Access to Information, Using Automated Tools to Enforce the Segregation of Incompatible, Functions, Using Governance, Risk, and Compliance Technology to Manage Internal Controls, Using Technology to Identify Trends, Validating Data and Information, Varying Control Activities in an SDLC Based on Risk
- Expectations Relating to Preventing or Detecting Material Omissions and Misstatements and Fraud ; Stakeholders today have higher expectations for effective internal control over external financial reporting in preventing and detecting material omissions and misstatements due to error and fraud.
  Topics include Assessing Fraud Risk, Assessing the Potential of Management Overridem, Cascading Responsibilities throughout the Organization and Measuring Results, Conducting Ethics Audits, Conducting Senior Financial Officer Visits, Employee Ethics Hotline, Evaluating Misconduct Reported through an Anonymous Hotline, Identifying and Analyzing

Risk of Material Omission and Misstatement Due to Fraud, Reporting Deficiencies to the Board, Taking Action when Deviations Occur

The quality and integrity of external financial reporting controls are perhaps the major issues that launched the development of the original COSO framework and then the SOX legislation. Public investors and government regulators historically relied on published enterprise financial reports, but those reports were sometimes misleading, were sometimes not issued in a timely manner, or occasionally were just fraudulent. Weak financial accounting standards and loose internal controls led to questionable external financial reports. Bad decisions were then made, based on those reports, but SOX rules and other factors now require an enterprise to devote more care to developing and issuing accurate, well-controlled external financial reports.

In applying the Framework, entities will find relevant approaches and examples in the Compendium of how organizations may apply the principles in the design, implementation and conduct of internal control over external financial reporting. These approaches and examples relate to each of the five components and seventeen principles set forth in the Framework.

4.2. DISCUSSION

Having integrated reporting today is seen primarily as an effective way to describe the ability of corporate entities to operate sustainably and maintain the value-creation potential. Its main method is to summarize and integrate key information about management, strategy, risks, operations, financial and non-financial activities.

The objectives of Sarbanes-Oxley Act (SOX) is to improve the quality of financial reporting and to restore investor confidence in the reliability of financial statements (Shi, et al, 2012). An important aspect of SOX is its internal control reporting requirements, which allow investors to be informed about the internal control quality of a company. Effective internal controls over financial reporting should lead to more reliable financial statements through the prevention and detection of procedural and estimation errors (Doyle et al., 2007a,b; DeFond and Jiambalvo, 1991).

Kam,et al (2021) found that the impact of the internal control system as a whole, as well as the impact of the five components of internal control individually (i.e. control environment, risk assessment, control activities, information & communication, and monitoring), are analyzed. Internal control, as an integrated system, has significant positive impact on firm innovation, as measured by patent applications. Rice and Weber (2012) also found that internal ciontrol has significant impact over financial reporting that leads a company to follow specific external financing choices to meet its financial needs.

Concerns arise among professionals in the application The Compedium. Karen, et al, (2013) mentioned that there is an additional burden that would impact to the organization applying the ICEFR. The Compendium or the external auditors who audit entities' systems of internal control view this document as a benchmark rather than as a non-comprehensive tool for implementation, the users may wind up performing non-essential work by moving from an acceptable implementation approach not included in the Compendium to an approach that is included in the Compendium.

It is said the the ICEFR is relevant for both large and small entities, while smaller entities likely will gain the greatest benefit from this document. Larger entities have spent significant resources of time and money in the design and implementation of strong systems of internal control.

The approaches and examples do not attempt to illustrate all aspects of the components and relevant principles necessary for effective internal control relating to external financial reporting objectives. Further, they are not sufficient to enable an organization to determine that each of the five components and relevant principles is present and functioning. Instead, the approaches and examples are intended to illustrate how principles may be present and functioning. Study results showed the importance of the integration of the five internal control components based on COSO framework and the need to apply them combined due to the positive effect in applying tasks and services transparently, ensure integrity and boost quality and efficiency of the entities. (Khersiat, 2020).

5. CONCLUTION

The Compendium provides practical approaches and examples that illustrate how the components and principles set forth in the Framework can be applied in preparing external financial statements. It is a supplemental document that can be used in concert with the Framework when considering internal control over external financial reporting.

While the Compendium is a valuable tool in the hands of companies that will rely on the COSO Framework in developing strong systems of internal control, it has the potential to lead to comparability at the expense of quality controls. Internal control over external financial reporting objectives should be consistent with generally accepted accounting principles that are suitable and available for an entity and appropriate in the circumstance.

All elements of the revised COSO internal control framework—up, down, and across—are important for establishing effective internal controls of the development and issuance of external financial reports. In the prior paragraphs, we summarized some important but general internal controls for external financial reports.

Well controlled and accurate external financial documents are very important and crucial for any enterprise's formal financial reporting. Any type of factual or timing error, even if unintentional, may affect investment markets, will be a major embarrassment for the enterprise and its senior management, and may result in governmental inquiries or actions. Errors or internal control shortcomings should simply not be allowed.

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